

In the United States Court of Appeals  
for the Ninth Circuit

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PACIFIC MAGNESIUM, INC., (FORMERLY SOCIAL MAGNE-  
SIUM, INC.), APPELLANT

v.

HARRY C. WESTOVER, INDIVIDUALLY AND AS COLLECTOR  
OF INTERNAL REVENUE FOR THE SIXTH DISTRICT OF  
CALIFORNIA, APPELLEE

---

ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF CALIFORNIA

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BRIEF FOR THE APPELLEE

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**BRIEF FOR THE APPELLEE**

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**OPINION BELOW**

The opinion of the District Court (R. 11-25) is reported at 86 F. Supp. 644.

**JURISDICTION**

This case arises on appeal from a judgment of the United States District Court for the Southern District of California, Central Division, in favor of the defendant. (R. 29-30.)

On March 12, 1948, within the time allowed by law, the taxpayer filed a claim for refund with the Collector



of Internal Revenue for the Sixth District of California, seeking a refund of \$30,487.39, plus interest paid thereon in the amount of \$4,877.98, plus statutory interest on these amounts, this being part of a deficiency in excess profits tax for the year 1944, plus interest, asserted by the Commissioner of Internal Revenue, and paid by the taxpayer to the Collector of Internal Revenue for the Sixth District of California, on November 14, 1947. (R. 3-4, 8, 71-76.) No action was had on the claim for refund and, after the expiration of six months, this action was commenced against the Collector of Internal Revenue, to whom payment had been made, by the filing of a complaint on September 23, 1948, to recover payment of the taxes and interest alleged to have been overpaid. (R. 2-7.) The jurisdiction of the District Court rested on 28 U.S.C., Section 1340.

The judgment of the District Court was entered on October 31, 1949. (R. 29-30.) Notice of appeal was filed by the taxpayer on November 30, 1949. (R. 35.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1291.

#### QUESTION PRESENTED

Was the court below correct in holding that the taxpayer received taxable income when its creditor settled a debt for less than its face amount, and in holding that the taxpayer did not receive a gift or a contribution to its capital?

#### STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations involved are set forth in the Appendix, *infra*.

## STATEMENT

A portion of the facts in this case was stipulated (R. 40-68), and a portion was adduced by testimony (R. 30-35), and by exhibits (R. 69-76).

Prior to November 20, 1944, P. H. Sheedy, individually, and as trustee and beneficiary, owned all the capital stock of two corporations, one being the taxpayer (then known as Socal Magnesium, Inc.) and the other being Socal Foundry. (R. 11-12, 41-42.) As of that time, the taxpayer was indebted to Socal Foundry in several respects, including one indebtedness on an open account for supplies, services, and equipment furnished by Socal Foundry to the taxpayer in 1943 and 1944. The amount of this open account indebtedness was \$39,335.07. (R. 43.) Socal Foundry was indebted to Sheedy on a promissory note in the amount of \$14,000. (R. 47.)

On November 20, 1944, Sheedy and Frank Gaines entered into a contract (R. 12-13, 42-43, 46-53), whereby Sheedy sold all his stock in Socal Foundry to Gaines and transferred to Gaines the obligation of \$14,000 which was owing to him from Socal Foundry. Gaines paid \$42,000 in cash to Sheedy, plus an additional \$14,000 for the note, and undertook to cause Socal Foundry (R. 49) "to compromise and settle its claim against" the taxpayer for the payment of \$4,000.

After the execution of the agreement, Gaines and his nominees were elected as the directors and officers of Socal Foundry in place of Sheedy and his nominees. (R. 13, 43.) Socal Foundry's new directorate then

adopted a resolution which, after reciting the taxpayer's indebtedness to it, provided as follows (R. 55) :

Whereas it is the belief of the directors of this corporation that said Socal Magnesium Inc. is unable to pay its said debt and that if this corporation can obtain the sum of \$4,000.00 from said Socal Magnesium Inc. in settlement of said debt, that it would be a wise and proper thing to do.

Now, Therefore, Be It Resolved that this corporation accept from Socal Magnesium Inc. the sum of \$4000.00 as payment in full of all monies and other things of value that may be due and owing to this corporation from Socal Magnesium Inc., \* \* \*.

Resolved Further that the President and Secretary of this corporation be and they are hereby authorized and directed to execute a General Release in the name of and for and on behalf of this corporation, and to affix the corporate seal thereto, releasing said Socal Magnesium Inc. from the payment of any monies owing to this corporation, except as aforesaid, in consideration of the payment of \$4000.00 by Socal Magnesium Inc. to this corporation.

In its tax return for 1944, Socal Foundry deducted \$35,335.07 as a bad debt. This arose from the cancellation of the debt owing from the taxpayer. The Commissioner of Internal Revenue did not disallow the deduction. Because of other deductions, the bad debt deduction resulted in no tax benefit to Socal Foundry. (R. 15, 45.)

The taxpayer, on its books, credited the amount of the indebtedness which was forgiven by Socal Foundry, namely, \$35,335.07 to "Capital Surplus" and debited



the same amount to "Accounts Payable, Socal Foundry." Socal Foundry and the taxpayer each kept their books and filed their income and excess profits tax returns on the accrual basis. (R. 44.)

At the time of the trial, Sheedy was deceased. The taxpayer offered the testimony of Sweeney, Sheedy's attorney, who testified that part of the consideration for which Sheedy sold the stock to Gaines was the undertaking that Socal Foundry would cancel the taxpayer's debt for \$4,000. He also testified that Socal Foundry carried out this purpose or motive in adopting the resolution to release the taxpayer for \$4,000, and that he was one of the directors at that time. (R. 34.)

The tax deficiency in this case arose from the fact that the Commissioner determined that, in computing its excess profits taxes, the taxpayer should have included in income the amount of the debt forgiven by Socal Foundry, namely, \$35,335.07, and that the taxpayer should not have included in its equity invested capital for 1944 any part of that amount. (R. 5.) The taxpayer's claim for refund (R. 71-76) and its complaint below (R. 5) were on the theory that Socal Foundry had made a gift of income to it, or that Sheedy had made a contribution to its capital.

The court below, in denying the taxpayer's claim, found that Socal Foundry did not intend a gratuitous forgiveness of the indebtedness, and that the purpose of the parties was to compromise the debt which was owing. It was also determined that no contribution of capital had been made to the taxpayer. Consequently, the court below held that the taxpayer was in receipt of taxable income in the amount of \$35,335.07, that no part

of that amount was includible in its equity invested capital, and that the taxpayer had not overpaid its excess profits tax. (R. 11-28.)

#### SUMMARY OF ARGUMENT

Whether the taxpayer was in receipt of taxable income when its creditor settled a debt for less than face amount, as the court below held, or whether the taxpayer's creditor intended to make a gift to it, as the taxpayer contends, which would not be taxable income, is a question of fact. The court below, considering all the evidence, concluded that the creditor did not intend to make a gift, and that the settlement of the indebtedness was a compromise or an accord and satisfaction. This finding is firmly supported by the record, including the provisions of the documents and the contemporaneous action of the creditor in claiming a bad debt deduction. While the testimony of the taxpayer's witness was that the creditor was not compromising a doubtful claim or one of dubious collectibility, the court below was not required to accept his testimony in preference to the other, contradictory evidence. Furthermore, he did not testify that the creditor intended to bestow a gratuity and, consequently, there is nothing in the record to show that the creditor did intend to make a gift.

The lower court's further conclusion that the taxpayer did not receive a contribution to its capital is also fully warranted by the record. The creditor, who released the claim for less than its face value, was not a stockholder of the taxpayer and could not have made a contribution to its capital. The taxpayer's sole stock-

holder did not release or forgive any indebtedness owing to him from the taxpayer, and, consequently, did not make a contribution to its capital. While the taxpayer asserts that the entire transaction should be recast and should be considered from the viewpoint of what the parties might have done, the court below was correct in holding that the intention of the parties and the tax consequences of what they did do should be controlled by the transaction which they did carry out, and not be governed by what they might have done.

In no event was the taxpayer entitled to add any part of the released obligation to its equity invested capital. If the taxpayer received income from the transaction, as the court below held, its equity invested capital would not be affected thereby until the beginning of the next taxable year. And, even if the taxpayer was the recipient of a gift or of a contribution to its capital by the release of the obligation, as the taxpayer contends, this forgiveness of indebtedness would not result in an increase in its equity invested capital.

#### ARGUMENT

**The Court Below Was Correct in Holding That the Taxpayer Received Taxable Income When its Creditor Settled an Indebtedness for Less than its Face Amount, and in Determining That the Taxpayer Did Not Receive a Gift or a Contribution to Capital**

The issue in this case is whether the taxpayer realized taxable income in the amount of \$35,335.07 when its creditor settled an outstanding debt of \$39,335.07 for \$4,000, and whether the court below was correct in holding that, under the circumstances, the facts did not support the taxpayer's contentions that there was a gift to it or a contribution of capital of \$35,335.07.



It is well settled that the profit realized by a debtor whose obligation is extinguished by payment of an amount less than that which is owing, constitutes gain which is taxable income within the broad sweep of Section 22 (a) of the Internal Revenue Code (Appendix, *infra*). *Commissioner v. Jacobson*, 336 U. S. 28, 38-41; *United States v. Amer. Chicle Co.*, 291 U. S. 426; *United States v. Kirby Lumber Co.*, 284 U. S. 1, 3; Treasury Regulations 111, Sec. 29.22 (a)-13 (Appendix, *infra*).

The taxpayer, however, contends that the income which was realized was a "gift" to it from the debtor and, accordingly, to be excluded from taxable income under the provisions of Section 22 (b)(3) of the Internal Revenue Code (Appendix, *infra*). (Br. 11-20.) This contention, which is frequently made in cases of this kind, must be considered in relationship to the broad application to be given to Section 22 (a) and the more narrow construction to be given to Section 22 (b). As the *Jacobson* opinion points out in referring to these two sections (p. 49) :

The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy. \* \* \*

In considering whether the taxpayer here was the recipient of a gift, it should be emphasized that the issue essentially presents a question of fact, namely, whether the creditor was actuated by a donative intent, so that it can be concluded that a gratuity was bestowed on the debtor as a gift. Thus, in the *Jacobson* case it



was stated (p. 51): "The situation in each transaction is a factual one."

In the present case, the trial judge found as a fact that the debtor (R. 27) "had no intention of gratuitously forgiving such debt or any part of it" and, instead, that the transaction "was effected with the purpose of compromising the debt \* \* \*." These findings, of course, will not be disturbed on appeal unless "clearly erroneous," with proper regard being given to the opportunity "of the trial court to judge of the credibility of the witnesses." Rule 52 (a), Rules of Civil Procedure; *United States v. Yellow Cab Co.*, 338 U. S. 338, 340-342; *United States v. Gypsum Co.*, 333 U. S. 364, 394-395; *Ruud v. American Packing & Provision Co.*, 177 F. 2d 538, 540 (C.A. 9th). The evidence, we submit, amply justifies the trial court's conclusions, as will be apparent from a consideration of the circumstances of the case.

The undisputed, stipulated facts show that prior to November 20, 1944, P. H. Sheedy, individually, and as trustee and beneficiary, owned all the capital stock of the taxpayer (then known as Socal Magnesium, Inc.) and of Socal Foundry. (R. 11-12, 41-42). At that time, the taxpayer owed certain amounts to Socal Foundry, including an indebtedness of \$39,335.07 on an open account for supplies, services, and equipment furnished by Socal Foundry to the taxpayer in 1943 and 1944. (R. 43.)

On November 20, 1944, Sheedy and Frank Gaines entered into a contract (R. 12-13, 42-43, 46-53) whereby Sheedy sold to Gaines all his stock in Socal Foundry, and a note of \$14,000 which was owing to him from Socal

Foundry. Gaines paid \$42,000 in cash to Sheedy (plus an additional \$14,000 for the note) and undertook to cause Socal Foundry (R. 49) "to compromise and settle its claim against" the taxpayer for the payment of \$4,000.

On the same day, after the execution of the agreement, Gaines and his nominees were elected as the directors and officers of Socal Foundry in place of Sheedy and his nominees. (R. 13, 43.) Socal Foundry's new directorate then adopted a resolution which, after reciting the taxpayer's indebtedness to it, provided as follows (R. 55):

Whereas it is the belief of the directors of this corporation that said Socal Magnesium Inc. is unable to pay its said debt and that if this corporation can obtain the sum of \$4000.00 from said Socal Magnesium Inc. in settlement of said debt, that it would be a wise and proper thing to do.

Now, Therefore, Be It Resolved that this corporation accept from Socal Magnesium Inc. the sum of \$4000.00 as payment in full of all monies and other things of value that may be due and owing to this corporation from Socal Magnesium Inc. \* \* \*.

Resolved Further that the President and Secretary of this corporation be and they are hereby authorized and directed to execute a General Release in the name of and for and on behalf of this corporation, and to affix the corporate seal thereto, releasing said Socal Magnesium Inc. from the payment of any monies owing to this corporation, except as aforesaid, in consideration of the payment of \$4000.00 by Socal Magnesium Inc. to this corporation.

Socal Foundry, in its tax return for 1944, deducted \$35,335.07 as a bad debt on account of the cancellation of the debt owing from the taxpayer. This deduction was not disallowed by the Commissioner of Internal Revenue. (R. 15, 45.)

In addition to the stipulated facts, the only other evidence offered by the taxpayer was the testimony of Sweeney, Sheedy's attorney, Sheedy being deceased at the time of the trial. Sweeney testified that "part of the consideration" for which Sheedy sold the Socal Foundry stock to Gaines was the undertaking that Socal Foundry would cancel the taxpayer's debt for \$4,000, since otherwise Sheedy "would probably lose \* \* \* or would be obliged to pay more money into" the taxpayer. He also testified that such was the purpose or motive of Socal Foundry in adopting the resolution to release the taxpayer for \$4,000, and that he was one of the directors at that time. (R. 33-34.)

The evidence conclusively negates any possible suggestion that Socal Foundry was actuated by donative motives in settling the obligation for less than its face amount, or that the taxpayer was in any manner the recipient of a gift which would be excluded from income under Section 22 (b) (3). The trial court concluded, on all the evidence, that Socal Foundry did not intend to make a gift, but that there was some dispute concerning the amount of the obligation or the ability to collect the debt, and that the final release of the taxpayer by Socal Foundry constituted a valid compromise of the claim or an accord and satisfaction. (R. 20-21, 27.) Under this view of the evidence, it is plain that no gift was



made. The recitations in the agreement between Sheedy and Gaines (R. 48), together with the fact that the agreement itself (R. 49) provided that Gaines would cause Socal Foundry “to compromise” the claim, plus the fact that the corporate resolution of Socal Foundry (R. 55) stated that the directors of Socal Foundry believed that the taxpayer would be unable to pay the full amount and that it would be “a wise and proper thing” to accept the sum of \$4,000 “in settlement” of the debt, certainly support the trial judge in his appraisal of the evidence. Significant, too, in ascertaining what were the creditor’s motives, is the fact that in its 1944 tax return Socal Foundry claimed a bad debt deduction for the amount which was released. (R. 15, 45.) In reference to this, the court below stated that the taking of this deduction (R. 21):

also fits into this pattern. They all spell clearly the compromise of a debt by the acceptance of a smaller sum.

In all cases of this character, the contemporaneous acts of the parties performed at the time when the effect of the transaction on tax liability was not uppermost <sup>^</sup> [sic] in their minds should prevail over subsequent attempts to give to it a different interpretation. \* \* \*

The taxpayer’s attempts to minimize the effect of this by pointing to the fact that Socal Foundry received no tax benefit from the deduction. (Br. 27.) This, however, serves to confirm, rather than to detract from the significance of the matter. Since the deduction gave Socal Foundry no tax benefit, there would have been no possible reason for it to misrepresent the situation in



its tax return. Consequently, the deduction represents an unbiased insight into how Socal Foundry, the alleged donor, viewed the matter at that time. The fact of the deduction demonstrates that Socal Foundry did not consider that it made a gift, but that it did, as the court below held, settle or compromise an indebtedness which was uncollectible in full. In the final analysis, Socal Foundry's intent is decisive of whether it intended to make a gift.

The taxpayer (Br. 18) also points to the financial statements as showing that the taxpayer was actually solvent at the time (R. 54), and as being inconsistent with the conclusion that the parties were settling an uncollectible debt. But there is nothing in the record which would compel the conclusion that this information was then available to the parties or that they acted on it. Furthermore, it does not negate the lower court's conclusion that the parties compromised the matter because there may have been some dispute concerning the existence of the whole claim.

The taxpayer's entire argument on this point (Br. 11-20) seems to be that the trial court should have disregarded all the positive evidence on which it relied and, instead, should have accepted the somewhat contradictory testimony of Sweeney, Sheedy's attorney, to the effect that no compromise of an indebtedness was involved. We do not at all concede that the trial judge, who saw and heard the witness, could be compelled to accept this testimony, particularly since it contradicted the written instruments and contradicted the fact that Socal Foundry considered that it was entitled to a bad debt deduction. *Ruud v. American Packing & Provi-*

*sion Co.*, *supra*, pp. 540-541. See also *Quock Ting v. United States*, 140 U. S. 417, 420-421; *Andrew Jergens Co. v. Connor*, 125 F. 2d 686, 689 (C.A. 6th). However, it should be pointed out that his testimony, even if it should be given full credence, does not begin to establish any basis for the taxpayer's contention that it was the recipient of a gift from Socal Foundry. Indeed, his testimony is to the contrary for he stated that Socal Foundry's release of the claim for \$4,000 was part of the "consideration" for the sale of the stock and that this motive did "transmute itself to Socal Foundry." (R. 33.) Since he was one of the directors of Socal Foundry when it adopted the resolution (R. 34), his testimony is absolutely inconsistent with the existence of any donative intent on the part of Socal Foundry. And, despite the various convolutions by which the taxpayer seeks to impute Sheedy's motives to Socal Foundry at a time when Sheedy was no longer connected with it (Br. 14-16, 17-18, 20), there is not one particle of evidence, and none is pointed to by the taxpayer, that Sheedy intended that Socal Foundry should make a gift. Indeed, the very testimony on which the taxpayer relies, namely that the release of the obligation was part of the consideration for the sale of the stock, shows that the contrary was true. Thus, even if the trial court should have accepted this testimony to the exclusion of everything else in the record, and even if the taxpayer could somehow impart Sheedy's motives to Socal Foundry, there would still be no basis for the taxpayer's culminating assertion that (Br. 20) "this forgiveness, made for that purpose, was a gift by Foundry, which

purpose generated from its sole stockholder.”

We submit that the trial court’s view of the evidence is the proper one and shows that there was a settlement of an indebtedness, not a gift. We also submit that, no matter how else the evidence be appraised, there is no possible basis for concluding that Socal Foundry intended to make a gift to the taxpayer when it accepted a lesser amount in payment of the indebtedness.

The taxpayer advances what purports to be two alternative arguments, but which, on analysis, really come down to the same basic contention, namely, that Sheedy made an indirect capital contribution to the taxpayer in the amount of the debt which was forgiven by Socal Foundry. (Br. 21-28.) Before considering this argument, it should be emphasized that the taxpayer’s theory of a capital contribution by Sheedy is completely inconsistent with the first alternative argument, namely, the taxpayer (Pet. Br. 11-20) was the recipient of a gift from Socal Foundry.

Although the taxpayer does not state its argument in ultimate terms, it will readily be appreciated that the taxpayer must be contending that the situation should be viewed the same as though Socal Foundry had assigned its claim against the taxpayer to Sheedy, who then forgave the indebtedness to the taxpayer as a contribution to its capital, or as though Sheedy had sold his stock to Gaines, not for \$42,000 in cash, but for \$77,335.07 (\$42,000 plus \$35,335.07), and that Sheedy then contributed \$35,335.07 to taxpayer’s capital to enable it to pay off its indebtedness in full to Socal Foundry.



The court below, we believe, answered this contention correctly by saying (R. 21-22) :

If, as plaintiff contends, the effect of the transaction is as though the \$35,335.07 had been added to the price demanded by Sheedy for the transfer of the stock, and, after receiving it, Sheedy had donated it to the plaintiff, the answer is that the transaction was not handled in that manner. And, neither Sheedy nor Gaines, contemporaneously, treated it as such. But even if we assume that this was the intention, their actions evidence a contrary intention. And, as between the two, in a matter of this character, acts speak more eloquently to a court.

The transaction, quite clearly, was not handled in the altogether different manner in which the taxpayer now suggests the parties might have proceeded. The fact that they did not carry out their transaction in this other way is, as the court below observed, strongly indicative that such was not their intent. And, of course, whether the transaction was a compromise of an indebtedness, a gift of income by Socal Foundry, or a capital contribution by Sheedy, largely depends on the intention with which the parties acted. Furthermore, even though the ultimate tax consequences here involved might have been different if the parties had consummated a different transaction, that does not constitute a reason for avoiding the tax consequences which attend the transaction which the parties did carry out. *Founders General Co. v. Hoey*, 300 U. S. 268, 275; *United States v. Cumberland Pub. Serv. Co.*, 338 U. S. 451, 455-456; *Frederick Smith Enter. Co. v. Commis-*



sioner, 167 F. 2d 356, 361-362 (C.A. 6th); *Becker v. Bank of Commerce Liquidating Co.*, 102 F. 2d 633, 638 (C.A. 8th), certiorari denied, 308 U. S. 578; *Biddle Avenue Realty Corp. v. Commissioner*, 94 F. 2d 435, 437 (C.A. 8th); *Taft v. Commissioner*, 92 F. 2d 667, 669 (C.A. 6th), affirmed, 304 U. S. 351.

In this connection, it is important to observe that the tax liabilities of the other parties would have been different if they had carried through the other transaction to which the taxpayer attempts to assimilate this one. Thus, Socal Foundry would not have been entitled to a bad debt deduction if the taxpayer's indebtedness had been fully paid. Furthermore, if Sheedy had received \$77,335.07 for his stock, instead of \$42,000, the taxable consequences to him might have been different.

The fact remains that Socal Foundry, not Sheedy, was the creditor and released part of the claim. The Court below, we submit, properly held that the taxpayer did not receive a capital contribution from Sheedy when Socal Foundry accepted \$4,000 in full payment of the taxpayer's debt. Socal Foundry, not being a stockholder of the taxpayer, quite obviously did not make any capital contribution to the taxpayer. And Sheedy, the sole stockholder, released nothing to the taxpayer and he could not make a contribution to its capital.

One final matter should be mentioned. Part of the deficiency in this case arose from the fact that the Commissioner had determined that taxpayer had erroneously included in its equity invested capital for the period of November 20 to December 31, 1944, a proportionate part of the \$35,335.07 released by Socal Foun-

dry. (R. 5, 28, 68, 71, 75.) If, as the court below held, the taxpayer was in receipt of taxable income as a result of the transaction, it was correct in holding that there was no increase in taxpayer's invested equity capital in 1944 (R. 28) for the income, at most, would be reflected in the taxpayer's earnings and profits account and would not appear in equity invested capital until the beginning of the next taxable year. Section 718(a)(4), Internal Revenue Code (Appendix, *infra*). The taxpayer has made no assignment of error in this respect. Furthermore, even if the taxpayer were correct in contending that there was a gratuitous forgiveness of indebtedness by Socal Foundry, or a forgiveness of indebtedness by Sheedy which amounted to a contribution to capital, there would be no basis for claiming any increase in equity invested capital. *Carlisle Tire & Rubber Co. v. Commissioner*, 168 F. 2d 816 (C.A. 3d); *George Hall Corp. v. Shaughnessy*, 67 F. Supp. 748 (N.D. N.Y.); *Liberty Mirror Works v. Commissioner*, 3 T.C. 1018; *Doylestown & Eastern Motor Coach Co. v. Commissioner*, 9 T.C. 846.

## CONCLUSION

In view of the foregoing, the judgment of the District court should be affirmed.

Respectfully submitted,

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MARCH, 1950.

## APPENDIX

## Internal Revenue Code:

## SEC. 22. GROSS INCOME.

(a) *General Definition*.—"Gross income" include gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. \* \* \*

(b) *Exclusions from Gross Income*.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

\* \* \* \* \*

(3) [As amended by the Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 111 (a)] *Gifts, Bequests, Devises, and Inheritances*.—The value of property acquired by gift, bequest, devise or inheritance. There shall not be excluded from gross income under this paragraph, the income from such property, or, in case the gift, bequest, devise, or inheritance is of income from property, the amount of such income. \* \* \*

\* \* \* \* \*

(26 U.S.C. 1946 ed., Sec. 22.)



SEC. 718. [As added by Section 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition*.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

\*                      \*                      \*                      \*                      \*

(4) *Earnings and Profits At Beginning of Year*.—The accumulated earnings and profits as of the beginning of such taxable year;

\*                      \*                      \*                      \*                      \*

(26 U.S.C. 1946 ed., Sec. 718.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.22(a)-13. *Cancellation of Indebtedness*.—(a) *In General*.—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See section 29.22(a)-17.) In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

\*                      \*                      \*                      \*                      \*

Sec. 29.22(a)-16. *Contributions to Corporation by Shareholders.*—If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. (See sections 29.22(a)-13 and 29.24-2.)

Sec. 29.22(b)(3)-1. *Gifts and Bequests.*—Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. If the gift, bequest, devise, or inheritance is of income from property, it is not to be excluded from gross income. An amount of principal paid under a marriage settlement is a gift. As to alimony or an allowance paid upon divorce or legal separation, see section 29.22(k)-1.